

Are Lease Options a Good Idea?

By MainStreet.com Staff Writers

The current state of the economy has made the housing market difficult for both buyers and sellers for two very different reasons. For buyers, the main problem is the credit crunch. Despite historically low rates, loan standards have tightened making it challenging for many buyers to qualify for a mortgage. For sellers, the main problems are falling home prices and competition in the market for the relatively small pool of buyers who can qualify for a mortgage. One technique that can help both buyers and sellers is a lease option.

With a lease option, also called rent-to-own, potential buyers enter into an agreement to rent a home for a specified term. At the end of the term, the buyers have the option to purchase the home at an agreed upon purchase price. Typically, with a lease option agreement, the rent is slightly higher than the market rate, and a portion of the rent is refunded to the buyer if the option is exercised. This rent premium serves as both an incentive for the seller to take the home off the market and incentive for the buyer to purchase the home at the end of the term. If the buyer chooses not to buy, the seller keeps the premium.

Lease options offer a number of benefits to sellers. For one, they expand the pool of buyers to those who can afford to make payments on a home but may not be able to qualify for a mortgage yet. With a lease option, there is no promise of a sale, but at least the seller has help covering the home costs rather than having the home languish on the market indefinitely. The seller also still gets the mortgage interest tax deduction during the option period.

Lease options can also be a good deal for buyers who don't have enough of a down payment or a high enough credit score to qualify for a mortgage. If a buyer believes that their financial situation will change during the option period, this is one way to get in a home sooner. The option period allows the buyer to test out the home and neighborhood before making a large commitment. If the buyer chooses to purchase the home, the rent rebate can help with the down payment or closing costs on the mortgage.

Lease options are not always win-win situations, however. Buyers need to be careful not to enter into such agreements with sellers who are in danger of losing their home to foreclosure due to financial distress. Buyers should get the seller's credit report and a title report on the property. There are also cases in which unscrupulous sellers have evicted buyers or refused to sell after the option term. These situations can result in costly legal battles. Buyers should be sure to read contracts carefully and consult an attorney to make sure there are no hidden clauses.

Additionally, when a purchase price is locked in, either the buyer or seller can lose out if the market value shifts one way or the other. One way to guard against this is to use a "right of first refusal" clause instead of an "option to purchase" clause. With a right of first refusal clause, at the end of the option term the buyer still has the option to buy but the purchase price is negotiable. The seller cannot sell the property without first allowing the buyer the opportunity to match the purchase price.